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ANALYSIS:

THE NON-INVASION OF POLAND

Ernest Schneider

During the year which has elapsed since a wave of strikes initiated profound changes in Poland, we have repeatedly heard predictions that the Red Army would invade its closest and largest ally. Although the invasion threat is very much alive at this writing, the interesting question now is less whether the Red Army will move than why this option was not chosen months ago--when it would have been somewhat less onerous than it is today.

Those who predict a Russian military move can cite abundant evidence to support their case. The Soviet Union has twice used force in Eastern Europe under circumstances similar to the current Polish drama: Hungary in 1956 and Czechoslovakia in 1968. Even the timing--another interval of about twelve years--is right. In Hungary, Prime Minister Imre Nagy was swiftly propelled by events to re-establish a multi-party system and leave the Warsaw Pact. While avoiding these mistakes, Czechoslovak First Party Secretary Dubcek was presiding over changes in the Communist Party that were transforming it, in Moscow's eyes, into an instrument of counter-revolution.

By now, Poland has already passed several thresholds of orthodoxy which go beyond anything which transpired in Czechoslovakia. The independent trade union Solidarity has usurped much of the power formerly wielded by the party and government, and a similar union of independent farmers has been legally established.

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ANALYSIS:

FINANCIAL INNOVATION

Irving Leveson

Technology has become more important than interest rates in driving change in the rapidly evolving financial services industry. Until recently, the major pressures for change have come from inflation, as savers and investors moved funds in search of higher yields and as new arrangements develop to provide protection against inflation and economic risk. Technologies which allow a rapid transfer of funds have allowed the system to respond much more quickly to changing conditions and have made possible the development of new institutions and financial arrangements. Computer and communications technologies can be expected to provide extensive opportunities for businesses and consumers to direct transactions from offices and community locations. Technological change is having such a far-reaching impact on the

financial services industry that it is no longer dependent on high rates of inflation and

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ANALYSIS:

ISRAEL AND THE IRAQI BOMB

Lewis A. Dunn

On Sunday, June 7, 1981, Israeli warplanes attacked and apparently destroyed a 40-MW Iraqi nuclear research reactor. Justifying this unprecedented preventive strike, Israeli Prime Minister Menachem Begin asserted that this reactor was about to be used by Iraq to make nuclear weapons for use against Israel.

Since the mid-1970s, Iraq had been purchasing nuclear material and facilities that, once completed, could have been illegally used to produce enough plutonium for about one Hiroshima-type bomb per year.

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- AN INTERVIEW WITH OMB'S BILL SCHNEIDER
- THE ISRAELI ELECTION--AN ANALYSIS
- THE FAILURE OF ECONOMICS EDUCATION
- AND A WORD FROM THE PRESIDENT OF THE HUDSON INSTITUTE



Notes from the Director...

A REEMERGENT AMERICA

Ten years ago, as talk of an expansive new decade dominated discussions of the early 1970s, few anticipated the enormous economic, social, political, and military dislocations that were soon to occur. The sudden end to an extended period of high economic growth in the developed nations was marked by the emergence of, among other things, a ten-fold increase in oil prices introduced and sustained by OPEC, double-digit inflation on a global scale, sharp declines in productivity growth, and the large-scale breakdown of traditional social values (which had already begun in the 1960s). Opposition to America's involvement in Vietnam, and by extension, to the entire U.S. defense effort, grew substantially and defense spending declined steadily as a percentage of GNP. All of these factors--economic, social, and military--gave rise to a national climate dramatically different from that of the previous 25 years.

Many people who discuss the 1980s assume, like their counterparts a decade ago, that this new decade will very likely repeat the experiences of the recent past, i.e., continuances of low economic growth,

upward pressure on energy prices, double-digit inflation (or something close to it), and stagnant defense spending as a "norm." I disagree with most of this projection. Although I do not expect a return to the growth rates characteristic of the period between 1947 and 1973, I do foresee a good possibility for substantial improvements over the next several years. I believe the U.S. will respond successfully (the degree of that success depending on the specific programs of the Reagan Administration and Congress) to the many problems associated with inflation, defense, energy, governance, and changing values. Thus, I see a renascent America entering a "boom" period which, if the proper policies are developed and carried through, could extend well into the decade, and perhaps even beyond.

Barring political problems in the Middle East, and maybe even with them, I do not see another substantial rise in energy prices. In fact, I expect energy prices to decline over the next few years. Similarly, though inflation rates will initially subside only grudgingly, they are most unlikely to remain at their current levels for long, at least in the developed countries. Over time, the adjustments made to recent energy price increases and high inflation rates will gradually exert a cumulative influence on the course of events, leading eventually to higher growth rates than those evident at the end of the 1970s and the beginning of this decade.

On the other hand, the 1980s will probably witness severe political and military challenges to the international system, in particular to the position of the U.S. as the more dominant of the two super-powers. How the U.S. responds

to these challenges will, in large measure, determine the role of the U.S. in world affairs for the remainder of the century. Fortunately, the Reagan Administration appears to recognize this fact and is beginning to take steps, onerous though they are, to restore American power and prestige.

President Reagan is in a unique position to foster the "boom" I foresee. Some of the positive developments I project, especially improved short-term economic prospects, would probably occur anyway. But with the proper policies, Reagan can give this resurgence staying power by, for example, cutting federal spending, taxes, and red tape. Reagan can also, through the force of his personality and political skills, create a new conservative electoral coalition which could institutionalize the social, economic, and political change he is seeking to carry out.

—Herman Kahn

Future Events...

On September 13-18, there will be a seminar on "Business and Domestic Concerns for the 1980s" at Hudson Institute. On October 1-4, there will be a special seminar for Chief Executive Officers at Seven Springs Conference Center, Mt. Kisco, New York. On October 18-23, there will be a seminar on "International Security Issues for the 1980s" at Hudson Institute. This last seminar will help launch the Hudson's Center for National Security, about which you will hear more in the next issue. If you have any questions about any upcoming Hudson activity, please call Hanne Nielsen, at 914-762-0700.

The Hudson Dialogue:

WILLIAM SCHNEIDER, JR.

Dr. Schneider is the Associate Director for National Security and International Affairs at OMB. Before joining the Reagan Administration, he was with the Hudson Institute, engaged in research in national security policy. He also worked for the House Appropriations Committee, Subcommittee on Defense. The Hudson Communique spoke to him on July 12, 1981.

H.C.: Dr. Schneider, from your vantage point at OMB, what is the outlook for DoD expenditures under the Reagan Administration?

W.S.Jr.: The Reagan Administration has proposed increasing DoD total obligational authority (TOA) from \$196 billion proposed by the Carter Administration, with real growth projected by the previous administration of 4-5 percent over the next five years, to \$222.4 billion with 7 percent real TOA growth projected through FY 1987. These estimates are sensitive to economic assumptions, especially economic growth rate forecasts and to a considerable degree, inflation expectations. Although these growth rates are high by recent experience, it should be noted that real defense expenditure, save for Vietnam war-related operating expenditures, has been below that expended in FY 1964 until the current fiscal year. Moreover, the proposed increase in expenditure is the smallest postwar defense build-up in relation to GNP.

H.C.: How are the additional resources invested?

W.S.Jr.: Owing to the the large

number of claimants for additional defense resources, the administration has sought to restrict new investment into areas most closely allied to its overall strategic objectives. These objectives have been expressed in a new document prepared by the DoD known as Defense Guidance, FY 1983-1987. This document has provided direction to those preparing the Program Objective Memoranda (POM)--the document which expresses the individual services request for funds/programs in the next fiscal year. As a result, approximately \$6 billion in programs will be eliminated from the "Carter base" in FY 1983 to free resources for programs congruent with the policies of the new administration. The major substantive areas of investment include: 1) restoring the strategic balance in the modernization of strategic delivery systems; 2) reducing shortfalls in the readiness of currently deployed forces to initiate and sustain combat; 3) initiating programs to modernize U.S. general purpose forces to cope with the threat anticipated in the late 1980s and beyond; 4) improving the ability of U.S. forces to deploy and sustain operations in remote areas of the world, including, but not limited to, the Indian Ocean littoral; and 5) improving the ability of U.S. command-control-communications-intelligence (C³I) to meet U.S. war-time requirements.

For reasons of accumulated shortfalls in both modernization and readiness/sustainability, and the new policy emphasis expressed in No.4, the Navy has commanded the largest share of new investment. A policy of defense procurement at economical acquisition rates has also increased the level of investment in the Air Force.

H.C.: There has been substantial public support for this in-

vestment; can this support be sustained?

W.S.Jr.: Public support for increased defense investment--particularly at a time when non-DoD functions are experiencing budget reductions is difficult to predict as there are no good modern precedents. The significant decline in the international environment we are now witnessing appears likely to induce a protracted period of international tension until U.S. military power is restored as an effective deterrent to overt assaults on our interests. If the restoration of U.S. military power is well managed and executed in an effective manner, I believe public support will be sustained. The difficulties of doing so should not be underestimated. The real growth in defense investment has not been sustained for a period of more than three years in the postwar period.

H.C.: Can you discuss briefly the major policy change associated with a shift in resources in the field of foreign assistance?

W.S.Jr.: Three basic preferences have emerged in administration policy formulation: 1) security assistance will be emphasized over development assistance; 2) bilateral assistance will be emphasized over multilateral programs; and 3) friendly states will be the preferred recipients of U.S. assistance.

Elements of this policy have appeared in the form of new guidelines governing access by friendly nations to the U.S. defense market, and a 40 percent increase in security assistance in FY 1982 over the amount proposed by the previous administration.

H.C.: Thank you, Dr. Schneider.

POLAND (Cont. from page 1)

Even the police are trying to form an "independent" union. Roman Catholic mass is regularly televised, Solidarity publishes its own weekly newspaper, and, though censored, Polish newspapers are routinely printing material which is alarming to the Soviet leader-

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ship. Indeed, the official Soviet press has been denouncing anti-socialist tendencies in Poland for months; in June, the Soviet Party bluntly indicated its dissatisfaction with the leadership of the Polish Party. Nevertheless, that leadership remains in power as final preparations are being made for an extraordinary Congress of the Polish Party in mid-July. And still the Red Army has not struck.

The basic reason is very simple: like most leaders, the Russians prefer easy victories to bloody battles. Those who point to the precedents of Czechoslovakia and Hungary, not to mention Afghanistan, ignore the failure of Stalin to invade Yugoslavia in 1948 and Khrushchev to invade Poland in 1956--as well as the absence of Soviet soldiers from the battlefields of Korea and Vietnam. Although Poland is both bigger and more strategically located than Hungary or Czechoslovakia, the key point is that the Polish people, including some units of the armed forces, would stoutly resist a Russian invasion. Not only would the military price of invasion be horrendous, far greater than suppressing the unorganized freedom fighters of Budapest, invasion would involve incalculable risks of escalation within Europe and perhaps even confrontation with the United States. Furthermore, the attendant economic, financial, diplomatic, and ideological costs would be staggering. And the prospect of administering a bankrupt and prostrate Poland is enough to daunt even the most militant Soviet leaders.

Nevertheless, an invasion might be engineered by means of an internal conflagration in Poland, which the Soviets might feel constrained to quell, at almost any cost. Khrushchev faced this kind of dilemma when revolt exploded in Hungary in 1956. The route to conflagration is provocation.

This kind of scenario has already been attempted: the beatings of Solidarity leaders last March very nearly precipitated a general strike--which could easily have led to violent clashes between workers and the regime. Only the sangfroid of such essentially moderate leaders as Lech Walesa of Solidarity, First Party Secretary Stanislaw Kania, and Prime Minister Wojcieck Jaruzelski prevented the bloodshed which such provocations are designed to cause. Fortunately, the enormous influence of the Polish Catholic Church has been exerted to preserve the Polish nation from the ordeal of invasion, and it remains an invaluable force for stability.

Just as the Czars were sometimes forced during the 19th century to accept a more liberal regime in Poland than that which prevailed in Russia itself, Leonid Brezhnev may have to tolerate even more unorthodoxy on his Polish flank. However, although grasping the Polish nettle would be very painful, no one can be sure that Russia will remain passive, especially if the Party Congress radically revises the way Poland has been ruled since 1947. Nevertheless, I am betting that Poland will survive another perilous summer without its dreams of more freedom and more independence being shattered by Russian tanks. No iron law of history ordains that the Soviet empire is immune to the kind of forces which have led to the dissolution of other imperial domains.

Mr. Schneider's extensive experience with European affairs includes many years with Radio Free Europe and the U.S. Foreign Service in Germany, Austria, and the Netherlands.

ANALYSIS:

THE 1981 ISRAELI ELECTION

Edward S. Boylan

As of this writing, it is still unclear just who has "won" the election in Israel. What is clear is that neither Likud, led by Prime Minister Menachem Begin, nor Labor, led by challenger Shimon Peres, has won a majority of the 120 seats in the Knesset, and that both parties will have approximately the same number of seats.

Thus, as was true for all past governments, Israel will once again be ruled by a coalition regime. What is unclear, however, is just who will head the coalition, Begin, or Peres. Much will depend upon the final distribution of the remaining Knesset seats among the various minority parties, and negotiations between them and the two major parties.

At this point, it would appear that Menachem Begin will remain as Israel's Prime Minister. The largest of the minority parties are the various religious parties which have far more affinity to Likud than to Labor. For Peres to establish any form of working majority would require him to either establish some rapprochement with the religious element or to gain the support of practically all the remaining splinter groups.

It is possible, though not likely, that neither party will be able to put together a coalition. The various minority parties will undoubtedly have their "price" for joining the coalition, and it may not be possible for either major party to reconcile the conflicting demands. (The story is told of the two Jews on a desert island who, within the course of a year, built three synagogues.) Were that to occur, a new round of elections would have to be held.

One major result of the election, however, is already clear. Israel seems far more on the road to a two-party system than ever before. In the current Knesset, Likud and Labor share 75 seats. In the next Knesset, they will share about 100 seats, a very significant jump. The long-term outlook for Labor would seem to be especially bright. Many Israelis voted for Begin, not Likud. Having already suffered two serious heart attacks, one doubts that Begin will be able to do battle three or four years from now, the next time one would expect a general election in Israel.

Shimon Peres, on the other hand, ran a rather lackluster campaign, and one suspects that many voted for Labor despite Peres, not because of him. Thus, one should see a growth in support for Labor in the next election, possibly leading to a majority for Labor in the Knesset.

As support coalesced in Israel around the two major parties, the individual splinter parties have lost considerable strength. The National Religious Party will have 5 or 6 seats in the new Knesset, as opposed to 12 in the current one. When Moshe Dayan announced formation of his Telem Party, the polls showed it would win 10-12 seats. In point of fact, Telem won only 1 seat--Dayan's.

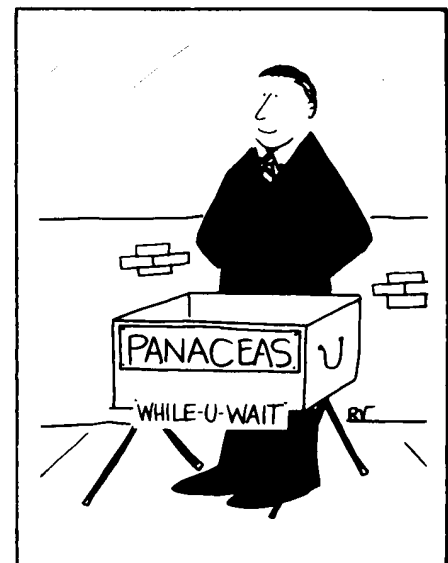
Clearly, any coalition which is formed will only have a narrow ruling majority. One should not assume, however, that the resulting government will be fragile or tentative in leading the nation. In the last year or so, Prime Minister Begin did not have a very large working majority, yet his government lasted longer than practically all previous governments. Nothing is as effective in imposing party discipline than the clear understanding

that rebellion will lead to new elections and the possible loss of one's own job. Only with the passage of time, however, will it be clear who will be at Israel's helm over the next months and years.

Dr. Boylan is Chairman of the Department of Mathematics, Rutgers University, Newark College of Arts and Sciences, and a consultant on strategic and Middle East issues to the Hudson Institute.

HUDSON CELEBRATES 20TH

July 21st marked the 20th anniversary of the founding of the Hudson Institute. In 1961, Herman Kahn, then a researcher at the RAND Corporation, and Max Singer decided that they would create an institution that would concentrate on public policy problems. In 1960, Herman Kahn became nationally prominent as his book, On Thermonuclear War, hit the best seller lists. Since that time, the Hudson Institute has been a leader in contributing to the understanding and the solution of complex issues facing America.



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BOMB (Cont. from page 1)

While there are technical deficiencies with International Atomic Energy Agency (IAEA) safeguards, it is highly probable that any such diversion--which most probably would have entailed reconfiguring the research reactor to place a blanket of natural uranium around its core and changing operating procedures--would have been detected by the IAEA. The provision of the France-Iraq nuclear cooperation agreement under which French scientists and technicians would have remained at the nuclear facility through 1989 also made it highly unlikely that Iraq could have acquired nuclear explosive material without being detected.

Nonetheless, the likelihood of detection need not have deterred Iraq from violating international safeguards and its legal obligations under both the Treaty on the Non-Proliferation of Nuclear Weapons and the agreement with France. Iraq might have been ready to risk international sanctions--assuming that, because of their dependence on Iraqi oil as well as other economic ties, the countries of Western Europe would be reluctant to support a multilateral punitive response. And Iraqi President Saddam Hussein's call for other countries to support the development of an Arab bomb--in his first public comment on the Israeli raid--clearly casts doubt on Iraq's long range intentions.

Iraq's quest for the bomb probably has been and will continue to be motivated in part by a desire to match and deter the nuclear weapons it firmly believes Israel to possess. An equally important incentive, however, may be a belief in the political and diplomatic utility

of nuclear weapons. Acquisition of the bomb would support Saddam Hussein's aspirations to preeminence in the Persian Gulf. It would also shake up the Middle Eastern status quo, which is unacceptable to Iraq. Indeed, once Iraq's possession of the bomb raised the spectre of a nuclear Arab-Israeli war and of damage to vital oil resources, it is highly likely that the United States and other Western countries would have been considerably more ready than they now are to pressure Israel for political concessions in a comprehensive Middle East settlement.

By contrast, an Iraq craving for nuclear weapons to use as soon as possible to destroy Tel Aviv--the most plausible target given the Arab populations of Jerusalem and Haifa--probably has been less of a driving force. Saddam Hussein's caution and careful calculation of risks in his war with Iran suggests that, whatever Begin contends, the Iraqis would not fail to comprehend the varied dangers of using nuclear weapons against Israel--not least that of Israeli nuclear retaliation against Baghdad.

This is not to say, however, that Iraqi nuclear weapons would not be used in a nuclearized Middle East. The threat of nuclear retaliation may not suffice to deter, for example, the unauthorized use of nuclear weapons against Israel by a fanatic group of Iraqi military men. Or a terrorist group might steal and use a bomb against Israel. And, in another Arab-Israeli war, conventional clashes might quickly escalate to nuclear exchanges. But perhaps even more likely is either an Iraqi nuclear weapon accident in Iraq or the unintended detonation of a nuclear weapon during a military coup d'etat in which control of those weapons had become a sought-after bargaining chip.

Israel's preventive action

has derailed and delayed, but not ended, Iraq's apparent effort to acquire nuclear weapons. While France may be more reluctant under the government of President Mitterand to assist in rebuilding the Osirak reactor--a decision made easier by the fact that at least for the moment Iraq is no longer supplying a large percentage of French oil--other routes to the bomb are still open to Iraq. For instance, using its oil money to buy expertise and following Pakistan's example and relying heavily on the purchase of gray market components and materials, Iraq might secretly build a small Manhattan project-type plutonium production reactor. Its success will depend most on its ability to keep its activity secret or, barring that, to mount better defense against the next Israeli preventive strike.

Finally, Iraq's motivations to acquire nuclear weapons have only been strengthened by Israel's military strike. Injured national pride, Iraq's claim to status in the Persian Gulf, and Iraqi domestic politics all demand a redoubling of efforts to acquire nuclear weapons. Not least, by its own actions, Israel has demonstrated not simply the military risks of Arab efforts to acquire nuclear weapons, but also the potential political payoffs of possessing those weapons. Saddam Hussein now definitely knows that Israel will feel threatened once Iraq acquires the bomb--perhaps sufficiently threatened that it might be vulnerable to outside pressure to make concessions to head off a nuclear conflagration in the Middle East.

Dr. Dunn is Hudson Institute's specialist on nuclear non-proliferation issues. His book, Containing the Genie: Nuclear Proliferation in the 1980s, is forthcoming.

FINANCIAL (Cont from page 1)

interest rates for rapid innovation. Even with relatively low inflation, technological impacts are so powerful and businesses and consumers so sensitized that the changes take on a life of their own. Under scenarios involving anything but a rapid rise in inflation, the march toward deregulation and a more general withering away of boundaries between traditional markets and institutions will continue to be strong. Many new opportunities will be created in the process. The adjustment of the financial services industry to inflation, technology, consumerism, and other conditions is part of a larger process of the adjustment of the U.S. economy to structural changes. This process of adjustment allows the economy to operate more efficiently, overcoming bottlenecks and facilitating innovation in nonfinancial sectors.

These observations are preliminary findings from a major study, "The Future of the Financial Services Industry," which Hudson Institute has undertaken. The study is assisted by a prominent advisory group of leaders in the industry and a working group of experts in particular fields. Sponsorship includes Merrill Lynch, the Capital Group, and the Beneficial Corporation. A final report and a conference to disseminate findings are being planned for the end of the year. Plans are being developed for follow-on studies and continuing programs to investigate the implications of changes in financial services for the roles of institutions, growth of markets, services, business strategies, public policies, and performance of the economy.

*Dr. Leveson, Hudson's
Director of Economic Studies,*

has published numerous books and articles, including Western Economies in Transition, and The Economic Future of the United States (forthcoming 1981).

COMMENTARY:

THE FAILURE OF ECONOMICS EDUCATION

Max Singer

I believe that the following experience is a datum that is relevant to assessing the effectiveness of the way economics is taught in this country. However, since I am not an economist, I put forward this hypothesis quite tentatively.

Over the past dozen years or so, I have interviewed several dozen recent college graduates and recent PhD's interested in jobs in policy research. I have asked most of these recent graduates--who have had at least an elementary economics course, and in many cases, a number of other economics courses--the same question. Although I believe that the response that the question is intended to elicit is one of the most central and basic concepts in the study and practice of economics, in no case was the correct answer supplied.

Here is the question. An airport has the following problem: it has two parking areas--a small one immediately in front of the terminal and a large one some distance away. Every day the small parking lot fills up early in the morning and thereafter passengers who arrive by car shortly before flight time miss their planes because they have to park at the more distant lot and lose time getting back to the terminal. What can the airport do to make available to late-arriving passengers the service of being able to park quickly? The

answer, of course, is that the airport can raise the price of parking in the convenient lot.

In presenting the question, I tried hard not to frighten or confuse the person I was interviewing, and often gave hints. But neither sympathetic setting nor hints was sufficient to produce the right answer. Even after being given the answer, most of the recent graduates were unable to answer the further question: how high should the price be set? However, when presented with the straightforward suggestion that the price could be raised until it was observed that there were always some empty spaces in the convenient lot, most of them agreed that doing so would make sense.

Obviously this discussion omits many complexities. In at least some cases, other solutions or mixed solutions might be better than the use of price to ration the scarce resource. But in no case was my "correct answer" even raised as a possibility.

My impression from this experience is that most of these recent graduates understood, as an abstract matter, that price can often perform the function of rationing scarce resources and inducing an increase in supply. But it seemed that none of them grasped this concept in a way that they could use in thinking about practical situations or so that it came to mind as a potential approach to dealing with a real problem.

If bright graduates do not know, and were not effectively taught this in their economics courses, is it possible that economics teaching practice is profoundly flawed?

Mr. Singer, a founder of the Hudson Institute, is Deputy Director and heads the Washington office.

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A Word From the President...

We are particularly pleased with the Hudson Communique, and hope that you will be too. It has been a good many years since the Hudson Institute sent information regularly to its members, supporters, and friends. I hope you will let us know what kinds of articles you would like to read in future issues, and that you will give us the benefit of your reactions.

This effort is largely due to the presence of Robert Vasquez, who is at Hudson on an Intergovernmental Personnel Fellowship from the Federal Government. He serves as Editor of the Communique, and is very much responsible for its existence.

We expect to publish on a

regular basis in order to provide you with timely analyses of current events, and to keep you informed of what Hudson is doing. We would be pleased to add to our mailing list the name of anyone you feel might enjoy receiving a copy.

Herman Kahn is presently in Europe, along with Tom Pepper and Marie Josee Drouin. The purposes of their visits are to re-establish contact with European business, to conduct research, and to work on a book on Germany.

Colin Gray, Director of National Security Studies at Hudson, has a book coming out next month titled: MX ICBM and National Security (New York: Praeger).

-Gail Potter

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